

GRANTOR TRUST OVERVIEW



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I. Introduction

Long a staple of estate tax planning, a grantor trust can be a powerful tool in the elder lawyer's arsenal. All or any portion of a trust drafted to be "defective" for income tax purposes is classified as a "grantor" trust with respect to that portion of the trust. In the context of income taxation, the settlor (or occasionally another individual) is the deemed owner of the portion of the trust that triggers the grantor trust rules and is responsible for income tax liabilities (and perhaps benefits from tax attributes) associated with that portion of the trust.

The courts and Congress throughout the 1940s and 1950s devised the grantor trust rules to impede the ability of individuals to shift tax burdens to lower-bracket taxpayers (*e.g.*, children); the idea was to essentially nullify the transfer to trust (for tax purposes) if the transferor retained too much control. After the adoption of those rules, drafting an "unintentionally defective" trust might have created an undesirable result – perhaps a call to your professional liability insurer. But as the economic and tax climates have changed and asset protection planning has increased, the simultaneous divestiture of legal title by transferring an asset to trust while avoiding the complexities of the "usual" trust taxation rules presents an attractive strategy.

A trust gains "grantor" status by "failing" one of the rules enumerated in IRC §§ 673 through 678. Those sections provide a menu of options for designing an intentionally defective grantor trust. Generally they involve some sort of right or benefit retained by the grantor over the trust assets or beneficiaries. IRC §§ 671 and 672 provide, respectively, general rules and definitions.

The happy result of grantor trust status is that all income tax attributes of some or all of the trust (income, deduction, credit) flow through to the grantor and are reported on her Form 1040.² In this manner an individual can, for example, divest an asset yet retain the income, or transfer a residence but retain the capital gains exclusion on sale of the residence by the trust (all of which will be discussed in greater detail in other segments of the program).

II. IRC §§ 671 and 672: Basic Concepts and Definitions

A. Grantors (and Others) as Tax Owners

A grantor (or another person, for that matter) deemed the "owner" *of any portion* of a trust under the grantor trust rules is required to include in computing his or her taxable income those items of income, deductions, and credits that are attributable *to that portion* of the trust. Remaining items of income, deductions and credits (*i.e.*, those attributable to *other* portions

² Perhaps the clearest summary by the Service is in Rev. Rul. 85-13.

of the trust) are taxed to the trust, or beneficiary, as applicable, under the usual trust taxation rules of subchapter J of the IRC.

A critical definitional issue pertains to who is treated as the “grantor.” Particularly in the context of a D4A Trust established by a parent, grandparent, guardian or court the identity may be somewhat unclear.³

Generally, the regulations under Code section 671 deem any person who creates or funds a trust to be a grantor of the trust.⁴ A grantor, however, may not necessarily be the tax owner. A person may create a trust, but if that person made no gratuitous transfer to the trust or is directly reimbursed for a transfer to the trust, he or she may be the grantor of the trust, but not the owner. As noted above, a D4A Trust established by someone other than the disabled beneficiary is an example..

The converse may apply in certain limited cases. For example, a person who is not the grantor with respect to a trust (*i.e.*, she neither created nor funded any portion of the trust) may nevertheless be the tax owner with respect to any portion of the trust over which she has an unfettered withdrawal power that could benefit herself.⁵ As will be discussed further, this should be of concern only where the grantor has failed to retain (or grant to a nonadverse party) any power that would cause the grantor to be the deemed owner under the grantor trust rules.⁶ This might occur if a nongrantor trust enables a lone trustee to make discretionary distributions to herself. *Take Care!*

There may be more than one grantor and one owner.

It should also be clear, in the context of a self-settled or D4A Trust, that a trust “established” by a parent or grandparent may nevertheless be a grantor trust with respect to the disabled beneficiary to the extent the beneficiary’s assets have been transferred to the trust and the scrivener selects some triggering rule under Code sections 673 through 677 and drafts the appropriate power into the document.⁷

³ See, generally, 42 U.S.C. § 1396p(d)(4)(A).

⁴ Treas. Reg. § 1.671-2(e)(1).

⁵ *Id.* 1.671-2(e)(6) Ex. 4 and I.R.C. § 678(a)(1).

⁶ *Id.*

⁷ If sound benefits and tax planning indicate that grantor trust status with respect to the beneficiary is advisable, there are any number of provisions that can be inserted that should not create difficulties from a Medicaid or SSI standpoint. This outline discusses a number of those provisions further below.

B. Definition of Adverse Party, Nonadverse Party and Independent Trustee

1. “Adverse Party” is a key definition to master. **Know this definition.** The concept is important not because adverse parties are essential, but rather because “nonadverse parties” are so useful.⁸ An “adverse party” is any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A general power of appointment over trust property constitutes a beneficial interest in the trust, along with countless other possible interests.⁹ It logically follows that any individual who is not an adverse party is a nonadverse party.¹⁰

Example: Anthony has been given an income interest in a trust but Greta Grantor has retained a power to appoint the income interest, Anthony will be adverse with respect to that retained power of appointment because Anthony Adverse will be the loser if Greta exercises her power.

The rules are simply based on an understanding of human nature and the propensity of an individual to act in his or her best interests. An adverse party is less likely to be subject to the influence of the grantor because she might be motivated to take or withhold action to preserve her trust benefits. On the other hand, a nonadverse party is free of those motivations. In fact, if trust design calls for the use of a nonadverse party the grantor will select someone who is not a beneficiary and who will likely do exactly what the grantor wants done.¹¹

2. “Independent Trustees” are really a type of nonadverse party. Think of them as being nonadverse parties “who are really, really nonadverse.” The idea behind many of the adverse/nonadverse distinctions is that an adverse party is going to be affected by the exercise of a power and a nonadverse party will not be (and will likely have been chosen by the grantor to be nonadverse because he was likely to be quite compliant in any event).

⁸ As will be discussed further below, some of the retained grantor trust powers are not “retained” at all, but rather vested in someone other than the grantor who is a nonadverse party. The nonadverse party actually becomes quite an ally if the intent is to create a grantor trust without vesting troublesome powers in the grantor/beneficiary that could create Medicaid/SSI/Veterans benefits issues.

⁹ I.R.C. § 672(a).

¹⁰ *Id.* § 672(b).

¹¹ Mason, 26 NAELA News 18 (Oct./Nov. 2014).

An “independent trustee” on the other hand is a trustee who is a nonadverse party but somewhat more removed from grantor’s sphere of influence. The code defines such a person as someone who is a nonadverse party and also not a “related or subordinate party.”¹² An independent trustee can be given much more leeway to decide whether to apportion or distribute income or principal among various beneficiaries¹³ because, the theory goes, her independence makes it more likely that she will not be acting simply as the grantor’s surrogate. She’ll be . . . well . . . independent.

C. Determining Portions

Much confusion exists with respect to the meaning of “a portion of a trust” and the applicability of that phrase to the grantor trust rules. Many elder law attorneys do not understand that a trust may be a grantor trust as to a portion only, and not a grantor trust with respect to other portions (*i.e.*, subject to the “usual” trust tax rules for non-grantor trusts).

1. A trust portion can appear in one of three ways. Short of being the deemed owner of an entire trust (which is quite common), a grantor could be the deemed owner of the principal or the income, the owner of a pecuniary or fractional share of all trust income, deductions and credits, or the owner of income, deductions and credits attributable to a specific trust asset.

Elder law attorneys are most likely to encounter apportionment in the context of principal and income. To determine what items of income, deduction and credit are apportioned to income and principal, the regulations use the distributable net income (“DNI”) rules under IRC 643(a) applicable to non-grantor trusts.¹⁴ Those rules are discussed in the first part of this outline.

Portions may also be specific assets. For example, a trust owning a residence, cash, and securities could be designed as a grantor trust with respect to the residence, and a nongrantor trust with respect to all other assets.¹⁵

2. The most likely area for an elder law attorney to run afoul of the “any portion of” rules of IRC § 671 is in the area of reserved income interests. For example, the uninitiated may believe that by reserving an income interest they have created a

¹² IRC § 672(c).

¹³ IRC § 674(c).

¹⁴ Treas. Reg. § 1.671-3(c).

¹⁵ Although from a drafting perspective this could be a bit confusing.

grantor trust that will preserve favorable attributes of grantor trust status with respect to corpus – notably a preservation of the capital gains exclusion on sale of a principal residence under Code section 121.¹⁶ But items of capital gain are not included in the “income” portion of a grantor trust because under the usual DNI rules capital gains are allocated to principal. The reservation of a power that will result in grantor trust status with respect to income may not create the desired result with respect to corpus unless some other reserved power triggers grantor trust status with respect to corpus. In such a case, the grantor will be treated as owner of only those items of trust income, deduction, and credit allocated to income and not to principal.¹⁷

III. IRC §§ 673 - 678: The Operational Rules

The grantor trust provisions, while complex, can be conceptualized in a simple fashion. A grantor trust is merely a trust over which the grantor has retained (or often given to certain nonadverse parties) one or more powers that cause the trust (or a portion thereof) to be deemed owned by the grantor.

Think of the various powers as something of a dashboard of switches that may be toggled on or off during trust design to accomplish the strategic goals (Grantor trust with respect to income? Grantor trust with respect to principal? Grantor trust with respect to specific asset?). Once clear on strategy, “pick your switch and flip it on or leave it off.”

Another useful idea: Start drafting with a trust in which the grantor has retained no power whatsoever after trust funding . . . then begin to add back in those powers/benefits you wish for the grantor to retain.

A summary of the basic rules follows. We’ll drill down much more deeply in later program segments. Any of the following may create a grantor trust with respect to a trust or an applicable portion.

SEE THE GRANTOR TRUST CHEAT SHEET ATTACHED

IV. IRC § 673 Reversionary Interests

The grantor is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent (5%) of the value of such portion. In most

¹⁶ See VIII.B beginning p. 19.

¹⁷ Treas. Regs. §§ 1.677(a)-1(g) (example 1); 1.671-3(b). For an interesting case on point *see* *Goldsby v. Comm’r*, T.C. Memo 2006-274 (trust income beneficiary denied pass through of items attributable to corpus).

elder law or special needs contexts a significant reversionary interest in a grantor with asset protection motives is not attractive.

On the other hand, because the section requires the 5% to be calculated on the basis that the trustee will exercise the maximum discretion in favor of the grantor,¹⁸ and because one who funds a trust is considered a “grantor” with respect to the portion she funded,¹⁹ this provision will generally guarantee that a D4A trust will be considered a grantor trust with respect to the beneficiary if it was truly a “self-funded” trust.²⁰

While IRC § 673 is not of much interest outside the D4A context, it does have an interesting interplay with a number of other grantor trust sections and illustrates how a trust power or retained benefit can be caught up by more than one grantor trust provision.²¹

V. IRC § 674 Power to Affect Beneficial Enjoyment – The Grantor Trust Monster

A. Overview

Section 674 is, to my thinking, the most important (and involved) of the grantor trust rules. Master this, and you’re halfway home.

Generally, a grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.²² If an adverse party’s consent or cooperation is necessary to effect an alternate disposition of assets, the power does not create a grantor trust. In the VA benefits planning context this can be useful when the same power can trigger gross estate inclusion (and stepped-up basis).²³

Example 1: Edith Bunker funds a trust for the benefit of her daughter Gloria and her husband Michael Stivic. Income to Gloria and Michael for the joint lives of Edith and Archie, remainder to Gloria and Michael. Edith retains a right to appoint trust income and

¹⁸ IRC § 673(c)

¹⁹ Treas. Reg. § 1.671-2(e)(1).

²⁰ *I.e.*, the beneficiary’s assets were used to fund the trust, as opposed to some other party’s assets.

²¹ Rather than get ahead of ourselves, this will be discussed under IRC § 677.

²² IRC § 674(a).

²³ See discussion of estate inclusion and basis step-up at X.C.1 and X.C.3.

principal in any manner that does not constitute a general power of appointment. This is a grantor trust under IRC § 674(a).

Example 2: Edith is afraid of creeping periods of forgetfulness, so she gives her dear friend and neighbor Louise Jefferson the power to appoint income and assets among Edith's descendants and their spouses. This is a grantor trust because Louise is a nonadverse party.

Example 3: Edith retains a special power of appointment as provided in Example 1, but her power is exercisable only upon the written approval of Gloria. This is NOT a grantor trust under IRC § 674(a) because Gloria is an adverse party.

There are ten exceptions: Some are powers the grantor or any other person may hold, two are powers an independent trustee may exercise, and one is a power a trustee (other than the grantor or the grantor's spouse) may exercise, without causing the grantor to be taxable as the owner of the trust. Accordingly, if the goal is to create a grantor trust reliance on a simple power to affect the beneficial enjoyment of a trust without verifying whether the power falls within one of the following exceptions is not a good practice. On the other hand, if the goal is to avoid grantor trust status then understanding and using the exceptions to your advantage would be wise. Here we go . . .

B. Exceptions

1. IRC § 674(b)(1).

A grantor is not taxable as the trust's owner merely because any person (including, even, the grantor as long as he is acting in a fiduciary capacity as trustee or co-trustee) may use trust income to discharge a legal support obligation of the grantor.²⁴ However, if trust income is in fact used to discharge the support obligation as described in IRC § 677(b) the income applied will be includible in grantor's ordinary income.²⁵

2. IRC § 674(b)(2).

This power is not a significant power in the elder and special needs law context. A "postponed power" (*i.e.*, a power to affect a trust's beneficial enjoyment that is subject to the occurrence of an event) will create a grantor trust unless the event with respect to which the power could apply is remote enough to have a value less than five percent (5%) of the value of the trust or portion of the trust if it were treated as a reversionary interest.

²⁴ IRC § 674(b)(1); Regs. § 1.674(b)-1(b)(1).

²⁵ Treas. Regs. § 1.677(b)-1.

In other words, if the power was exercised effective as of the future event and it was treated as a reversionary interest a grantor trust would result if the interest is worth more than 5% of the trust (or applicable portion).²⁶ The analysis is the same as one would perform under IRC § 673 with respect to reversionary interests.

Example: Edith establishes a trust for the benefit of Gloria and Michael, but retains the right to appoint income and principal beginning ten years after the trust has been funded. Under relevant valuation principals²⁷ had Edith's power to appoint been a reversionary interest (*i.e.*, in ten years the trust would revert to her or her estate) the interest would be worth 25% of the trust assets. This is a grantor trust under IRC § 674(a) because her postponed power is not excepted by IRC § 674(b)(2).

3. IRC § 674(b)(3).

Contrary to what many believe, unless a bit of care is taken, a testamentary power of appointment alone may not create a grantor trust.²⁸ Anyone other than the grantor may be given a testamentary power of appointment without creating a grantor trust.²⁹ But if the grantor retains a testamentary power of appointment, things become a bit trickier.

Many practitioners believe that simply inserting a testamentary power of appointment in the grantor will create a grantor trust. While this may often be the case, it may not be; and when it is it may be in ways the drafting attorney had not foreseen. With respect to income not allocated to principal (*e.g.*, interest or rental income), if grantor's testamentary power of appointment is not accompanied by an "income accumulation" factor described below, then grantor trust status will not be obtained.

- (a) First, if accumulation of income is mandatory or there is discretionary authority (in either the grantor or a nonadverse party) to accumulate income, *and* the grantor's testamentary power of appointment extends to that accumulated income, the result *will* be a grantor trust.³⁰

Example: Edith establishes a trust that generally requires the distribution of all ordinary or accounting income to Gloria, subject to the power in Louise

²⁶ IRC § 674(b)(2).

²⁷ Call a CPA or valuation consultant; you're a lawyer, for Heaven's sake!

²⁸ *Id.* § 674(b)(3).

²⁹ Treas. Reg. § 1.674(b)-1(b)(3) (first sentence).

³⁰ Treas. Regs. § 1.674(b)-1(b)(3); *see also* Prv. Ltr. Rul. 201326011 for a perfect illustration.

Jefferson to indefinitely suspend the distributions. Edith also retained a testamentary power of appointment over the trust remainder. This is a grantor trust with respect to ordinary income because a nonadverse party (Louise) can elect to accumulate income for later distribution pursuant to Edith's testamentary power of appointment.

- (b) Second, even if there is no mandatory or possible discretionary accumulation of income but grantor does have a right to appoint trust corpus by will, any items of income allocable to trust corpus (*e.g.*, capital gains) under the trust agreement or local law will be attributable to grantor.

Example: Edith establishes a trust that mandates the distribution of all ordinary or accounting income to Gloria. Edith also retained a testamentary power of appointment over the trust remainder. During the year, trust assets generate interest and rental income. The trustee also sells a number of trust assets and generates capital gains income. The interest and rental income will be includible in DNI under IRC § 643(a). On the other hand, if the capital gains income is allocable to principal under the local principal and income act or the trust agreement, the capital gains income will be attributable to the grantor because of his testamentary power.³¹

Example: In the previous example, if the trust agreement requires immediate distribution of all capital gains income to Gloria (together with all other income) the trust will not be a grantor trust with respect to any portion of the trust³² notwithstanding that Edith has retained a testamentary power of appointment.

4. IRC § 674(b)(4).

A grantor is not taxed as a trust's owner if the grantor simply retains a power to allocate the beneficial enjoyment of trust corpus or income among charitable beneficiaries.³³

5. IRC § 674(b)(5).

³¹ Treas. Reg. §§ 1.674(b)-1(b)(3) (last sentence), 1.671-3(b)(3).

³² Recall, a mere testamentary power of appointment, unless coupled with some type of potential income accumulation, does not create a grantor trust. IRC § 674(b)(3).

³³ That's nice. IRC § 674(b)(4); Treas. Reg. § 1.674(b)-1(b)(4).

- (a) A grantor is not taxed as a trust's owner simply because she or a nonadverse person (or both) has a power to distribute corpus among one or more beneficiaries if the power is limited by a “reasonably definite external standard” (*i.e.*, similar to the ascertainable “health, education, maintenance or support” under IRC §§ 2041 and 2514).³⁴

Example: Edith establishes a trust with a mandatory income interest in favor of Gloria, remainder to Gloria and Michael upon Edith’s death. Edith’s sister (Gladys) is trustee, and she has the discretionary authority to make distributions for the health, education, maintenance and support of baby Joey Stivic. Notwithstanding that the power in a nonadverse party (Gladys) to make discretionary distributions of corpus would generally create a grantor trust under IRC § 674(a), this is an excepted power under IRC § 674(b)(5) because it is subject to a reasonably definite standard.

Note *carefully*, if the decision-maker’s authority *seems* to be limited by a reasonably definite external standard, but the trust agreement also says that the decision-maker’s determination is “conclusive,” then the power will not be limited by a reasonably definite external standard.³⁵ Depending upon drafting goals, that should be avoided . . . or could be very useful.

- (b) Further, distributions of corpus may be made to a current income beneficiary as long as the distribution of corpus is chargeable against the beneficiary’s proportionate share (and, in this case, the distribution need not be limited by a reasonably definite standard).³⁶

Example 1: Edith establishes a trust with a mandatory income interest in favor of Gloria and baby Joey for Edith’s life, remainder in baby Joey and Gloria. Pursuant to the trust agreement Edith may make distributions of principal to either baby Joey or Gloria for any reason at all, as long as the principal distributed reduces the proportionate share of the recipient that actually generates that recipient’s income (the easiest way to do this is simply divide the trust into shares and debit the recipient’s share). Edith has named herself as trustee. This is not a grantor trust notwithstanding that the grantor

³⁴ IRC § 674(b)(5)(A); Treas. Reg. § 1.674(b)-1(b)(5)(i).

³⁵ Treas. Reg. § 1.674(b)(5)(i) (penultimate sentence).

³⁶ IRC § 674(b)(5)(B); Treas. Reg. § 1.674(b)-1(b)(ii).

has discretionary power to alter the timing of the enjoyment of the corpus, she really isn't altering who ultimately receives those benefits.

Example 2: Edith establishes a trust with a mandatory income interest in favor of Gloria, remainder in Gloria. Edith may make distributions of principal to Gloria for any reason at all. This is not a grantor trust.

A couple of noteworthy points in the elder law context:

- First grantor trust status *will* result if the power in the grantor or a nonadverse person to distribute corpus to or among beneficiaries is *not* limited by a reasonably definite standard and the corpus so distributed is not charged proportionately to the distributee's share.
- Second, pursuant to flush language at the end of IRC § 674(b)(5), if the grantor or a nonadverse party retain the right to add a beneficiary or to a class of beneficiaries, the result will be grantor trust status.

Both of these could be extremely useful powers if the intent is to create a grantor trust with respect to principal without retaining additional powers that could create Medicaid "asset retention" issues, particularly if a nonadverse party is the powerholder.

Example: Edith establishes a trust with a mandatory income interest in favor of Gloria and baby Joey, remainder in baby Joey and Gloria. Edith names her sister Gladys as trustee. Gladys may make distributions of principal to either baby Joey or Gloria as she may deem to be in either of their best interests. This is not excepted under IRC § 674(b)(5) and this is a grantor trust with respect to Edith.

6. IRC § 674(b)(6)

Think of this as a little like the "flip side" of IRC § 674(b)(5) exception with respect to distributions of *corpus*. There are actually two subtly different exceptions here. Under subparagraph (A) a grantor is not taxed as a trust's owner if she or a nonadverse person (or both) has a power to distribute or apply *income* to or for any current income beneficiary or to accumulate the income for that beneficiary, provided that any accumulated income must ultimately be payable to *that* beneficiary, his estate, or to his appointees.³⁷

³⁷ IRC § 674(b)(6)(A).

Example: Edith establishes a trust with equal income interest in favor of Gloria and baby Joey for Edith's life, remainder in baby Joey and Gloria. Pursuant to the trust agreement Edith may make or withhold distributions of income to either baby Joey or Gloria for any reason at all, as long as the withheld income is added to the affected beneficiary's remainder share. Edith has named herself as trustee. This is not a grantor trust notwithstanding that the grantor has discretionary power to alter the timing of the enjoyment of the income because she really isn't altering who ultimately receives those benefits.

Under subparagraph (B) a grantor is not taxed as a trust's owner if she or a nonadverse person (or both) has a power to distribute or apply *income* to or for any current income beneficiary or to accumulate the income and add it to corpus, provided that any accumulated income that has augmented the corpus must, upon trust termination, ultimately be distributable to the current income beneficiaries in shares that are irrevocably specified in the trust agreement.³⁸ This is so even if it allows the grantor to shift income (ultimately) among the remainder beneficiaries.

Example: Edith establishes a trust with a discretionary income interest in favor of Gloria and baby Joey for Edith's life, and upon Edith's death remainder to baby Joey (2/3rd) and Gloria (1/3rd). Pursuant to the trust agreement Edith may make or withhold distributions of income to either baby Joey or Gloria for any reason at all, as long as the withheld income is added to the general corpus. Edith has named herself as trustee. This is not a grantor trust notwithstanding that the grantor has discretionary power to alter the timing of the enjoyment of the income because she really isn't altering the class of beneficiaries who will receive those benefits.

In my opinion, care should be taken if relying on one of these exceptions that a grantor not be able to alter the ultimate distribution of corpus through a testamentary power of appointment.

As with the (b)(5) exception relating to corpus, this exception does not apply if any person has the power to add a beneficiary or to the class of beneficiaries (other than after born or after adopted children).

7. IRC § 674(b)(7).

³⁸ IRC § 674(b)(6)(B).

A grantor is not taxed as a trust's owner simply because she or a nonadverse person (or both) reserves a power to withhold income from a current income beneficiary during any legal disability of the beneficiary or until such beneficiary attains age 21.³⁹ Again, this exception does not apply if the grantor has the right to add to the class of beneficiaries ultimately to receive the trust income or corpus (other than after born or after adopted children).

Example: Edith establishes a third party special needs trust for Gloria (who recently went on Medicaid) with a life income benefit, baby Joey is the remainder beneficiary upon Gloria's death. Edith is the trustee. The trust gives the trustee the power to withhold income distributions to Gloria if Gloria has been determined to be disabled. This is not a grantor trust.

8. IRC § 674(b)(8)

A power held by the grantor or a nonadverse person (or both) to allocate receipts and disbursements as between corpus and income, even though expressed in broad language, does not constitute a power to dispose of the beneficial enjoyment of the trust corpus or income that would cause the grantor to be taxed as the trust owner.⁴⁰ The regulations provide no further guidance, but it seems logical that this would apply to authority under a trust agreement to make fiduciary determinations of income and principal. For example, in the context of classifying receipt as between income and principal, regulations provide that "[t]rust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized."⁴¹

9. The "C" and "D" Exceptions Under IRC § 674.

Take a deep breath: These two exceptions apply only to powers exercisable by certain trustees (who, presumably, will be acting under a fiduciary standard). If there is no trustee power involved, don't waste your time on these exceptions.

(a) IRC § 674(c) -- Independent Trustee Exception

While the general rule is that a nonadverse trustee with certain powers to control beneficial enjoyment (including the right to apportion or accumulate principal or

³⁹ IRC § 674(b)(7).

⁴⁰ *Id.* § 674(b)(8).

⁴¹ Treas. Reg. § 1.643(b)-1 (the regulation then describes various adjustments that would be recognized if permitted under local law and the trust agreement . . . which is a topic totally beyond the scope of this summit).

income among beneficiaries) will trigger grantor trust status under IRC § 674(a), IRC § 674(c) provides an exception.

A grantor is *not* taxed as a trust's owner if an *independent trustee* has the power to distribute, apportion, or accumulate income or corpus to or for a beneficiary or a class of beneficiaries, as long as *no one* is able to add to or enlarge the class (after born children excepted).

An independent trustee is not the grantor, nor a related or subordinate party.⁴² A “related or subordinate party” in relation to the grantor includes the spouse, parents, descendants, siblings, employees, corporation or entity in which his holdings are “significant” (or an employee of such an entity) or a subordinate employee of an entity in which the grantor is an executive.⁴³

The idea is that an independent trustee is far enough removed from the grantor’s influence (that might be something of a legal fiction!) that this type of trustee should have more discretion without having that discretion attributed back to the grantor. Perhaps another way to think of this exception is the “Bank Exception.”

Caution: If the grantor retains the right to terminate the trustee and replace the trustee with another trustee who would not satisfy the conditions for this exception to apply (in this case, naming a successor who is not independent) this exception will not be available.⁴⁴

Example: Edith establishes a trust for the benefit of Gloria, Michael, baby Joey and any other later born descendants. Aleesta Mill Bank & Trust has been named as Trustee. Edith retains the right to terminate the trustee and name any other independent trustee of her choice as successor. This is not a grantor trust.

(b) IRC § 674(d) - The “Anybody But The Grantor or Live-in Spouse” Trustee Exception

A grantor is not taxed as a trust's owner if any trustee other than grantor or grantor’s cohabiting spouse (*no need for independent trustee*) holds the power to distribute, apportion or accumulate income (note: does not apply to principal) to or for a beneficiary or a class of beneficiaries, if the power is limited by a reasonably definite

⁴² *Id.* § 674(c)

⁴³ *Id.* § 672(c).

⁴⁴ Treas. Reg. § 1.674(d)-2.

external standard, and if *no one* can add to or expand the class of beneficiaries to receive either income or corpus (other than after born children).⁴⁵ It seems a testamentary power of appointment (or any other power of appointment) in anyone would knock this exception out because someone could expand the class of beneficiaries. Also, recall that if the determination of the trustee as to whether the “reasonably definite external” conditions have been met is “conclusive,” then the power is not subject to such a standard.

Unlike the IRC § 674(c) exception, above, any of the trustees may be related or subordinate to the grantor. The IRC § 674(c) power and the IRC 674(d) power are very similar other than the fact that the independent trustee has complete leeway of decision making and the ‘merely’ nonadverse (but potentially related or subordinate to the grantor) trustee is bound somewhat by the “reasonably definite external standard.”

Take care with the manner in which successor trustees are named. If a grantor has power to remove, substitute, or add trustees (other than a power exercisable only upon certain limited conditions such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) in a manner that could result in a successor trustee not necessarily being independent or nonadverse, a trust may not qualify under section IRC § 674(c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section IRC § 674(c) or (d), above. Conversely, if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section IRC § 674(c) or (d) the power does not cause grantor trust treatment. To further clarify, a power in the grantor to remove or discharge a nonadverse trustee on the condition that she substitute another nonadverse trustee will not prevent a trust from qualifying under section 674(d).⁴⁶

VI. IRC § 675 Retained Administrative Powers

A. Overview

Certain administrative powers exercisable by the grantor *or a nonadverse person*, or both, for the benefit of the grantor rather than for the trust beneficiaries will cause the trust to be taxable to the grantor as owner of the trust. The first three categories are of no use in the

⁴⁵ *Id.* § 674(d); Treas. Reg. § 1.674(d)-1.

⁴⁶ Treas. Regs. § 1.674(d)-2(a).

elder law context because they will render trust assets as available resources for Medicaid purposes; the fourth category contains a provision that is much more interesting. They are:

B. Specific Powers

1. Dealing at a Bargain – IRC § 675(1)

The existence of a power exercisable by the grantor or any nonadverse party to enable the “grantor or any person” to deal with trust assets for less than adequate and full consideration.

2. Loans at Great Terms – IRC § 675(2)

The existence of a power exercisable by the grantor or any nonadverse party to borrow trust assets without adequate interest and security.

(a) If you insist, use a nonadverse party!

In the elder law context, if you insist on using this power to create a grantor trust, *use a nonadverse party!* Keep in mind that any powers retained by the grantor could have adverse Medicaid availability issues.

(b) The Unfortunate Ms. Edholm

Mary Edholm established an irrevocable trust for asset protection purposes. In order to create a grantor trust, the scrivener inserted a provision that the grantor retained the right to “borrow” assets from the trust without interest and adequate security. Years later, the grantor applied for Medicaid and the trust assets were deemed available due to the provision. In court⁴⁷ the grantor argued that the provision was inserted merely for tax reasons so the trust would be deemed available *for tax purposes*.

Unimpressed, the court held that because there were circumstances under which payment could be made from trust (*i.e.*, interest-free loan on demand) the assets were deemed available.⁴⁸ In an interesting twist, the decision said that because the trust was deemed the grantor’s for tax purposes, it supported the welfare commissioner’s contention that the assets were available for Medicaid purposes.⁴⁹

⁴⁷ Edholm v. Minn. Dep’t of Human Servs. (Hennepin County Dist. Ct. 27-CV-11-23237) (June 17, 2013). This is an unpublished opinion; I have a copy available upon request.

⁴⁸ Recall the Medicaid rule that assets in a trust funded the beneficiary will be deemed available if they can be distributed to the beneficiary “under any circumstances.” 42 USC § 1396p(d)(3)(B).

⁴⁹ A bit like mixing Medicaid apples with tax oranges, in my opinion, but the opinion does underscore the fact that words in a trust agreement mean something; they are not “just there.”

3. Actually Borrowing – IRC § 675(3)

Unless the trustee is independent, if a grantor borrows trust assets (even with adequate security and interest) and fails to repay the loan before the end of the taxable year the trust will be treated as a grantor trust for the year.⁵⁰ Another handy use for independent trustees if you wish to avoid grantor trust status and the grantor insists on borrowing (but even then, it must be with adequate interest and security).⁵¹

4. Home of the Swap Power – IRC § 675(4)

This paragraph details three additional triggers. Two are fairly insignificant in the elder law context. One is highly significant.

- (a) Elder Law Boring. A power to vote or direct the voting of stock or other securities of a corporation *in which the holdings of the grantor and the trust are significant* from the viewpoint of voting control;
- (b) Elder Law Boring. A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations *in which the holdings of the grantor and the trust are significant* from the viewpoint of voting control;
- (c) Home of the Swap/Power of Substitution!

A grantor trust in both income and principal will result if the grantor or a nonadverse person *acting in a nonfiduciary capacity* (no trustees!) has the power to reacquire the trust corpus by substituting other property of an equivalent value. This particular power could be important to the elder law attorney.

COUNTER TO BAD ADVICE: Apparently some presenters at CLE seminars have recommended that the “swap” power be given to a nonfiduciary *adverse* party (perhaps a remainder beneficiary).⁵² This is NOT good advice. Admittedly IRC § 675(4) says the power can be exercised in a nonfiduciary capacity by *any* party, which could include an adverse party. On the other hand, the regulations are to the contrary, and they actually make sense. The regulations say the power must be

⁵⁰ This doesn’t apply if a loan with adequate interest and security is made by a trustee who is not the grantor or a related or subordinate party.

⁵¹ Risky, in my opinion, in the elder law context.

⁵² Thanks to TrustChimp Trust Summit alum and Pennsylvania elder law attorney Henry Levandowski for the heads up. I didn’t ask who this person was and Henry didn’t offer. I do not want to unnecessarily embarrass anyone.

exercised by any *nonadverse* party.⁵³ The “any party” approach runs counter to every other provision of the grantor trust rules, and I cannot help but wonder if the statutory discrepancy was an ancient legislative drafting oversight.⁵⁴

CAUTION: One potential line of attack that could be used by a regulator attempting to assert that trust assets are available for Medicaid purposes due to the retention of a power of substitution has surfaced in Colorado. Colorado Medicaid regulations provide that “If there are any circumstances under which payments from the trust could be made to or for the benefit of the individual . . . the portion of the corpus of the trust . . . from which payment to the individual could be made shall be considered as resources available to the individual.”⁵⁵ Apparently the Colorado Medicaid office interprets the provision to provide that if a trust contains either a power of substitution or a right to borrow assets without adequate security the assets will be deemed available. Further, if the trust is amended to remove the power, the “fix” date will be treated as “the date on which payment to the individual from the trust was foreclosed” with respect to assessing a transfer sanction.⁵⁶ Given that this is a power of “equal substitution” it is difficult to see how such a retained power is anything but the ability to enter into a fair market exchange (nonsanctionable).

Nevertheless, concerns over a “Colorado-like attack” could be avoided by simply vesting a power of substitution in some nonadverse party willing to lend her name to the cause.

Admittedly the section refers to “*reacquired*” and a grantor is the only person capable of “*reacquiring*” an asset, but the section also refers (applying generally to all “administrative powers”) to the power existing in the grantor or any nonadverse party (there is no limitation with respect to this power). In a closely analogous setting, the IRS published model charitable lead trust language in 2007.⁵⁷ Section 7 of the ruling provides model language for a grantor lead trust, and in model trust section 11 the IRS chose to structure the trust by giving a nonadverse party the power of substitution

⁵³ Treas. Reg. § 1.675-1(b)(4).

⁵⁴ See, also, Jonathan G. Blattmachr, *Income Taxation of Estates and Trusts*, § 4:5.3F at 4-87 (2011). Blattmachr notes that the regulation, in this case, would likely be enforced over the statute under the “broad deference” standard annunciated in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

⁵⁵ 10 Colo. Code Regs. § 2505-8.110.52.B.4.

⁵⁶ *Id.* § B.4.a.4.

⁵⁷ Rev. Proc. 2007-45.

under IRC § 675(4). The annotations to the model explain the use and specify that the exercise must be in a nonfiduciary capacity.⁵⁸ The following paragraph even explains that the drafter is free to choose some other power under the grantor trust rules if the power of substitution does not fit client needs.⁵⁹

VII. IRC § 676 Power to Revoke

If a grantor (or grantor's spouse) or any other nonadverse person retains the power to revest the title to the trust assets in the grantor, then the grantor shall be treated as the owner of such portion, even though no other provisions of IRC §§ 671-678 apply. Obviously, in the context of Medicaid and SSI this is not an attractive option.

VIII. IRC § 677 Retained Income Rights

A. Current Payment or Current Accumulation

A grantor is taxable as the owner of any trust or trust portion as to which she, or any nonadverse person (or both), has the ability to distribute, or accumulate for distribution, the trust income to the grantor or the grantor's spouse without the consent or approval of an adverse person.

The regulations clarify that a grantor who retains an income interest only is treated as owner of only ordinary income items, and not owner of any trust property properly allocable to principal.⁶⁰

B. Care With Portions

IMPORTANT: Do not reserve a simple income interest and expect grantor trust treatment with respect to both income and principal. For example, as noted above at II.C.2, a grantor who retains an income interest (and no other interest under the grantor trust rules that would treat him as owner of principal) and transfers a principal residence to the trust will not be able to obtain an exclusion from capital gains upon sale of the residence under IRC § 121.

A trust may trigger grantor trust status with respect to income if the grantor or a nonadverse party (without the approval of an adverse party) directs, or may direct, any of the following to occur:

⁵⁸ *Id.* § 8.09(1).

⁵⁹ *Id.* § 8.09(2).

⁶⁰ Treas. Reg. § 1.677(a)-1(g) (ex. 1).

1. Actual or constructive distribution of income to the grantor or the grantor's spouse (THIS IS THE CLASSIC INCOME ONLY TRUST!);
2. Accumulation of income for future distribution to the grantor or the grantor's spouse;
3. Application of income to payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (other than certain policies payable to charitable beneficiaries) (*this could be interesting in certain circumstances*).

Careful: There must be life insurance policies in existence and with respect to which it is possible for the trustee to pay the premiums. The power will not suffice if it is the mere statement of a power in the trust agreement and there are no such policies.⁶¹

4. Notwithstanding (1) or (2), above, a grantor will not be taxed on trust income simply because income *could* be used to discharge the grantor's or her spouse's legal obligation of support actual application or distribution of income to discharge the grantor's or her spouse's legal obligation of support; however, when income *is so applied*, the grantor will be taxable.

IX. IRC § 678 Person Other Than Grantor Treated As Owner

A. Overview

This section is the only grantor trust provision under which a person other than the grantor or a transferor to the trust could be the deemed owner of all or a portion of the trust for tax purposes. Note that each of IRC §§ 673 through 677 begin “The grantor shall be treated . . .” and IRC § 678(a) commences with “[a] person other than the grantor shall . . .”).

IRC § 678 is poorly drafted and is the source of confusion. From the face of the statute, it appears that a person with “power exercisable solely by himself to vest the corpus or the income therefrom in himself” will be the deemed tax owner.⁶²

B. An Ambiguous Exception

However, IRC § 678(b) applies an exception:

Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

⁶¹ With respect to any tax year the policies must be in existence and the trust must be capable of applying funds toward the payment of premiums. Iverson, Lorenz, 3 TC 756, 774 (1944); Weil, Joseph, 3 TC 579, 584 (1944).

⁶² IRC § 678(a)(1).

In other words, is this statute to be read that if the grantor and the other person are both treated as the owner of trust *income*, the rules of IRC §§ 674 through 677 trump application of IRC § 678(a) to the third party? For example, if grantor has retained an income interest IRC § 678(a) might not apply . . . or so it seems. On the other hand, a third person with power of corpus would, in fact, be treated as tax owner notwithstanding that grantor also has powers over corpus because IRC 678(b) would not apply . . . or so it seems. The statute actually is “something else.”⁶³

C. If It’s A Grantor Trust For Grantor . . . Move On.

The apparently correct reading of the section should be that if the grantor has retained any power over corpus *or* income under IRC §§ 674 through 677, the power will trump application of IRC § 678(a) to the third party. The key to answering the riddle is in the definition of “income.”

In the context of IRC § 678, “income” likely refers to “taxable income” as opposed to “trust accounting income.” The former includes both income allocable to corpus (*i.e.*, gains on sale or exchange of capital assets) and to trust accounting income (*i.e.*, ordinary income); the latter includes ordinary income.

1. Treas. Reg. § 1.671-2(b) specifies that for purposes of the grantor trust rules the term “income” refers to income for tax purposes and not trust accounting purposes and that if trust accounting income is being referenced the term “ordinary income” would be used. IRC § 678(b) uses the unmodified term “income” which refers to taxable income pursuant to the regulation. Accordingly, if a grantor and a third person are both deemed the owner of income allocable to either corpus or accounting income, then under IC § 678(b) the grantor would be treated as the owner (*i.e.*, IRC §§ 674 through 677 trump IRC § 678(a)).
2. IRC § 643(b) specifies that the term “income” refers to “income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law” (*i.e.*, trust accounting income) for the purposes of Subparts B, C, and D of Part I of Subchapter J. The grantor trust rules are in Subpart E, clearly omitted from the IRC § 643(b) reference. Combined with the reference under Treas.

⁶³ IRC § 678 reminds me of the motto of the State of North Carolina: *Esse quam videri* (“To be, rather than to seem”). The motto is a literal translation of a phrase from a sentence in Cicero's *On Friendship* (De Amicitia, chapter 26). The complete sentence in Latin is: *Virtute enim ipsa non tam multi praediti esse quam videri volunt*, which means something along the lines of “Fewer persons actually possess virtue than those who would seem to possess it.” I still believe it could apply to IRC § 678, but I digress.

Reg. § 1.671-2(b) discussed above, the meaning of “income” under IRC § 678(b) takes on some clarity.

Particularly in the context of veterans’ benefits planning, designing a trust to avoid application of the grantor trust rules to the grantor may be a sound strategy if a goal is to avoid trust tax attributes appearing on the grantor’s tax return. In connection with that strategy many may want to provide access to trust assets by allowing the trustee or some other person to make distributions to one or more individuals in a class of individuals.⁶⁴

Care should be taken to avoid application of IRC § 678(a) to an individual with the sole authority to order distributions to a class that includes herself. For example, a trust granting a trustee the authority to make distributions to descendants of the grantor “within the sole discretion of the trustee” will trigger application of the grantor trust rules to the trustee if the trustee is a descendant of the grantor. There are two ways to address the issue.

1. Perhaps the easiest method is to subject the decision-maker’s authority to the approval of another person, perhaps a sibling or some other trust beneficiary.⁶⁵ This approach not only avoids IRC § 678(a) issues, but may provide an added layer of security to trust assets by fettering an otherwise broad power residing in a single individual.
2. A second approach is to subject the decision-maker’s authority to an ascertainable or “health, education, maintenance and support” standard.

Crummey powers and inter vivos powers of appointment could also trigger this section with respect to a trust if the grantor has not retained powers under IRC §§ 673-677 that would cause grantor trust status with respect to the grantor (even if the beneficiary is unable to exercise the Crummey power due to minority or disability).⁶⁶

⁶⁴ As an aside (and a bit of drafting advice), if you wish to give a trustee who is also a beneficiary the power to make distributions that could involve distributions to the trustee/beneficiary you should check your state’s trust code to determine whether it includes a provision similar to Uniform Trust Code § 814(b). That section provides that a trustee/beneficiary (who is not the settlor) may not make a distribution to herself unless the trust agreement expressly opts out of the rule with a specific reference to the rule.

⁶⁵ Example: “The Trustee may elect within her sole discretion to make distributions of principal or income to any of grantor’s descendants subject to the advance written approval of a proposed distribution or distributions by one of grantor’s descendants not then serving as Trustee.”

⁶⁶ See, e.g., Rev. Rul. 81-6, 1981-1 C.B. 385. If you enjoy self-testing, go through the ruling and determine why the trust in question was *not* a grantor trust with respect to parent. The Service does not tell the reader that (which would have made the ruling much clearer). Or you can take my word for it.

X. Estate Inclusion for Stepped-up Basis

A. Overview

Most elder and special needs clients do not have issues with the federal estate tax inasmuch as they rarely have estates in excess of the estate and gift tax credit amount of \$15 million (2026 individual) or \$30 million (2026 couple).⁶⁷ Nevertheless, estate tax issues are important because the law in that area ties directly to the treatment of basis in the hands of various beneficiaries upon the death of the client.

As will be discussed in detail below, if stepped-up basis in various trust assets is an important planning goal, it is essential that the trust assets be includible in the grantor's gross estate as determined for estate tax purposes under the estate tax rules of the Internal Revenue Code (never mind that there may likely not be any issue with respect to whether any estate tax will be due). In a much-ballyhooed 2023 revenue ruling, the Service confirmed this position (which did not cause me much angst as it reiterated what I have always believed to be the case).⁶⁸

B. Basis Issues

1. Transferred Basis

Generally, transfers by gift result in Donee's basis being the same as the basis "in the hands of the donor."⁶⁹ Similarly, basis in property acquired by a transfer in trust (whether held by the trustee or later by a beneficiary) is "as it would be in the hands of the grantor . . ."⁷⁰

2. Stepped-up Basis

Notwithstanding IRC § 1015, however, IRC § 1014(a)(1) provides that "basis in the hands of a person acquiring the property from a decedent" shall be "the fair market value of the property at the date of the decedent's death." These are the so-called "stepped up basis" rules. If a grantor makes a gratuitous transfer to trust, upon the death of the grantor basis will be determined under either Code section 1015 (a transfer basis) or Code section 1014 (a stepped up basis).

⁶⁷ One Big Beautiful Bill Act of 2017, § 70106, Pub. L. No. 119-21, amending IRC § 2010(c)(3).

⁶⁸ Rev. Rul. 2023-2

⁶⁹ IRC § 1015(a).

⁷⁰ *Id.* § 1015(b).

Obviously, if stepped up basis is an important goal, compliance with Code section 1014 is necessary. In fact, as will be seen, the retention by the grantor of all the trust's income will result in gross estate inclusion under Code section 2036(a)(1) and, pursuant to Code section 1014(b)(9), result in stepped-up basis upon the grantor's death. That would be the end of the basis question. **The question becomes a bit more complex, however, if an income interest is not retained.**

Why? The estate tax inclusion rules of IRC §§ 2031 through 2046 and the grantor trust rules of IRC §§ 671 through 678 have considerable, **but not complete**, overlap. A grantor trust could very well be includible in a gross estate because one of the grantor trust "triggers" included in the trust agreement also triggers estate inclusion.⁷¹ But it isn't guaranteed.

C. Estate Inclusion

The gross estate rules are codified as Part III of Subchapter A of Chapter 11 of Subtitle B of the Internal revenue Code. In Plain English that refers to IRC §§ 2031 through 2046. Rather than provide a complete tutorial on estate inclusion rules, this outline touches on the most relevant and likely provisions affecting grantor trusts in the elder law or special needs law context.

As a preliminary matter, be aware that the following sections overlap in many cases; assets may be brought in to an estate under more than one section.⁷²

Also, unlike the grantor trust rules, if the grantor/decedent has not *retained* a power (which may or may not be exercised alone or in conjunction with others), the estate inclusion rules are not implicated. This is different from the grantor trust rules in which grantor may completely and irrevocably delegate a power to a nonadverse party.

1. IRC § 2036

IRC § 2036(a)(1) includes in an estate the value of property with respect to which the decedent "made a transfer" and retained an income interest or a life time right of possession or enjoyment. Note carefully that IRC § 2036(a)(2) also includes property with respect to which the decedent retained a right "*either alone or in conjunction with*

⁷¹ Or vice versa. *See, e.g.*, the denial of estate inclusion simply because a grantor trust contained a power of substitution under IRC § 675 (which does not trigger estate inclusion). CCA 200937028 (Nov. 18, 2008, released Sep. 11, 2009).

⁷² Think "and" . . . not "either-or."

any other person, to designate the persons who shall possess or enjoy the property or income therefrom.”

IRC § 2036 is analogous, to a great degree, with a number of grantor trust provisions. For example, IRC § 677 applies to an income interest retained by the grantor. IRC § 674 applies, in part, to the grantor’s right to designate who will receive the benefits of trust income. As with most grantor trust provisions, however, the grantor’s power must be exercised by the grantor or a nonadverse party and without the approval or consent of an adverse party.

IRC § 2036, and its interplay with the grantor trust provisions, offers an interesting planning opportunity: the power may be subject to the cooperation of “any person.” The regulations clarify that the other person may be an adverse party and that the capacity of the other person is immaterial (*e.g.*, the person could be the trustee).⁷³ If the other person is an adverse party, it should be possible to guarantee gross estate inclusion for basis purposes and avoid grantor trust status if that is a desirable objective (*e.g.*, perhaps for VA benefits planning purposes).

2. IRC § 2037

IRC § 2037 includes property transferred to trust over which the grantor retained a reversionary right the value of which exceeds 5% of the value of the property determined as of the date of death. The provision probably should not merit serious consideration in the elder and special needs law context because such a reversionary interest would raise significant Medicaid issues regarding the countability of trust assets.

3. IRC § 2038

IRC § 2038 is important and somewhat similar to IRC § 2036 (there is much overlap between the two sections). That provision includes in a grantor’s estate the value of property transferred to trust by the grantor if the property remains subject to a retained right “to alter, amend, revoke, or terminate” the ultimate enjoyment thereof. As with IRC § 2036(a)(1), this right may be in the grantor alone, or exercised “*in conjunction with any other person*.”

IRC § 2038 is analogous to IRC § 674. As discussed above, however, under IRC § 674 the grantor’s power must be exercised by the grantor or a nonadverse party and without the approval or consent of an adverse party.

⁷³ Treas. Reg. § 20.2036-1(b)(3).

Under IRC § 2038, estate inclusion will extend to powers retained during the decedent's life as well as to powers exercisable only upon death. A testamentary power of appointment will cause estate inclusion under IRC § 2038;⁷⁴ and it may or may not create a grantor trust under IRC § 674 (depending upon whether accumulated income is subject to testamentary disposition).

One miscellaneous note with respect to swap powers: A swap power or power of substitution (creating a grantor trust under IRC § 675) generally will not cause the inclusion of assets in an estate. After years of back and forth argumentation from commentators and Service general counsel memoranda, the Service recently clarified that a trust will not be includible in the grantor's taxable estate simply by virtue of being a grantor trust.⁷⁵ If stepped-up basis is the goal, be absolutely sure that the trust is includible in the grantor's gross estate under the inclusion rules. There is a large overlap between the grantor trust rules and the estate inclusion rules, but it is not a complete overlap.

4. IRC § 2041

IRC § 2041(a)(2) includes in an estate property transferred to trust which remains subject to a general power of appointment in the decedent. The decedent's right to exercise the power can be subject to exercise in conjunction with another person as long as that other person is a nonadverse party with respect to the property.⁷⁶

This power is a bit different from, say, IRC §§ 2036 and 2038 (which apply to property with respect to which the grantor had "at any time made a transfer") in that there is no requirement that the grantor has *retained* any power; a IRC § 2041 power can be conferred (in other words, there is no requirement that the grantor must have once owned the property in trust and conveyed it to the trust). **On the other hand, be very careful of general powers of appointment.** Pursuant to Section 501 of the Uniform Powers of Appointment Act, property subject to a general power created by the power holder would likely subject the property to the claims of the powerholder's creditors. Under Section 502, a general power given to another could subject property to that powerholder's creditors if the powerholder actually exercises the power.

⁷⁴ Marshall v. United States, 338 F. Supp. 1321 (D. Md. 1971); Priv. Ltr. Rul. 9437034.

⁷⁵ Rev. Rul. 2023-2.

⁷⁶ IRC § 2041(b)(1)(C)(ii).

GRANTOR TRUST CHEAT SHEET

673	Reversionary interest = 5% or more; Maximum trustee discretion assumed
674	
(b)(1)	Provision allowing income to legal support obligation OK; Actually do it – grantor trust
(b)(2)	Postponed power as long as less than 5%
(b)(3)	Testamentary power unless income accumulation
(b)(4)	Allocate among charitable beneficiaries
(b)(5)(A)*	Distribute <u>corpus</u> among beneficiaries if subject to reasonably definite standard
(b)(5)(B)*	Distribute <u>corpus</u> to income beneficiaries as long as chargeable to donee share
(b)(6)*	Power to distribute or accumulate <u>income</u> to any income beneficiary as long as: • Ultimately payable to THAT beneficiary or his assignees or estate, OR • Added to corpus and distributed to current income beneficiaries in irrevocably specified shares on termination
(b)(7)*	Withhold income during incapacity
(b)(8)	Reasonable allocations between principal and income
(c)*	Independent trustees can accumulate, distribute corpus or income among beneficiaries or class of beneficiaries
(d)*	Trustee (other than grantor or spouse) can accumulate/distribute income among beneficiaries if subject to reasonably definite standard
675	Admin Powers: Bargain dealing, great loans for grantor or nonadverse; grantor borrows and fails to repay before years end (unless trustee Independent); Power of Substitution
676	Power of revocation in grantor or nonadverse party
677	Income distributed or accumulated for grantor or grantor's spouse
678	Someone other than grantor

* No one may have the power to add to a beneficiary or class unless for after-born/after-adopted